

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
REPLY BRIEF**

77-6091

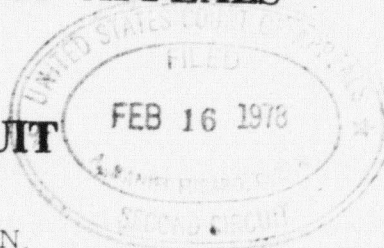
ORIGINAL
WITH PROOF
OF SERVICE

To be argued by
BERT L. GUSRAE

UNITED STATES COURT OF APPEALS

for the

SECOND CIRCUIT



SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

vs.

E. L. AARON & CO., INC., LAWN-A-MAT CHEMICAL AND
EQUIPMENT CORP., EDWARD L. AARON, PETER E. AARON,
NORMAN LAWRENCE SCHREIBER, DONALD DARWIN JACOBSON,
DANIEL DORFMAN, FERNANDO ERAZO,

Defendants,

and

PETER E. AARON,

Defendant-Appellant.

ON APPEAL FROM AN ORDER OF THE UNITED STATES
DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

— REPLY BRIEF OF DEFENDANT-APPELLANT
PETER E. AARON

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TABLE OF CONTENTS

	<u>Page</u>
TABLE OF CITATIONS	i
STATUTES AND RULES INVOLVED	ii
PRELIMINARY STATEMENT	1
REVIEW OF THE FACTS	2
POINT I:	
THE DISTRICT COURT ERRED IN FINDING APPELLANT AIDED AND ABETTED VIOLATIONS OF THE ANTI-FRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS.	4
A:	
THE ALLEGED FALSE REPRESENTATIONS MADE BY AARON & CO. EMPLOYEES	4
B:	
AARON HAD NO DUTY, RESPONSIBILITY OR POWER TO SUPERVISE A BRANCH OFFICE, WHICH BRANCH OFFICE WAS SUPERVISED BY A REGISTERED PRINCIPAL	6
C:	
SCIENTER IS A NECESSARY ELEMENT OF A CLAIM FOR RELIEF IN AN SEC INJUNCTIVE ACTION	10
D:	
THE DISTRICT COURT'S FINDINGS OF SCIENTER ARE CLEARLY ERRONEOUS, REQUIRING REVERSAL OF THE DECISION	13
POINT II:	
THE SALES OF UNREGISTERED STOCK CONFORMED WITH THE PROVISIONS OF RULE 144 AND THE SEC'S INTERPRETATIONS THEREOF, AND, THEREFORE, NO VIOLATION OF SECTION 5 OCCURRED	15

POINT III:

THE LOWER COURT ERRED IN GRANTING IN- JUNCTIVE RELIEF IN THE ABSENCE OF AARON'S <u>ACTUAL KNOWLEDGE OF THE FRAUD</u>	17
--	----

CONCLUSION	19
----------------------	----

APPENDIX

TABLE OF CITATIONS

	<u>Page</u>
<u>Arthur Lipper Corp. v. SEC,</u> 547 F.2d 171 (2d Cir. 1976), cert. denied, 46 U.S.L. 3432 (January 10, 1978)	11
<u>Carolina Securities Corporation,</u> 1976-1977 CCH Fed. Sec. L. Rep. ¶80,803 (Oct. 7, 1976) and ¶80,853.	16, 17
<u>Ernst & Ernst v. Hochfelder,</u> 425 U.S. 185 (1976)	10, 13, 17
<u>Faturik v. Woodmere Securities, Inc.,</u> (Current) CCH Fed. Sec. L. Rep. ¶96,063 (S.D.N.Y. 1977)	17
<u>Hirsch v. duPont,</u> 553 F.2d 750, (Current) CCH Fed. Sec. L. Rep. ¶96,011 (2d Cir. 1977)	17, 18
<u>Malik v. Universal Resources Corp.,</u> (Current) CCH Fed. Sec. L. Rep. ¶95,055 (S.D. Cal. June 3, 1976)	12
<u>Midwest Planning Investments, Inc.,</u> 42 S.E.C. 558 (1965)	10
<u>Rolf v. Blyth, Eastman Dillon & Co.,</u> (Current) CCH Fed. Sec. L. Rep. ¶96,275 2d Cir. 1978)	18
<u>Schmidt, Sharp, McCabe & Co., Inc.,</u> 42 S.E.C. 745 (1965)	10
<u>Securities and Exchange Commission v.</u> <u>American Realty Trust,</u> 429 F. Supp. 1148, 1976-1977 CCH Fed. Sec. L. Rep. ¶95,913 (E.D. Va. 1977)	11, 12
<u>Securities and Exchange Commission v.</u> <u>E. L. Aaron & Co., et al,</u> (Current) CCH Fed. Sec. L. Rep. ¶96,043 (S.D.N.Y., May 5, 1977)	2, 3

STATUTES AND RULES

Page

Securities Act of 1933, 15 U.S.C.
77a, et seq:

Section 5(a)(1), 15 U.S.C. 77c(a)	1
Section 5(c), 15 U.S.C. 77e(c)	1
Section 17(a), 15 U.S.C. 77q(a)	1, 12, 13

Securities Exchange Act of 1934, 15 U.S.C.
78a, et seq:

Section 10(b), 15 U.S.C. 78j(b)	1, 11, 12, 13, 17
---	----------------------

Rules under the Securities Exchange Act:

Rule 10b-5, 17 C.F.R. 240.10b-5	1, 12
---	-------

Rules under the Securities Act:

Rule 144, 17 C.F.R. 230.144	4, 13, 14, 15, 16, 17
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PRELIMINARY STATEMENT

This Reply Brief is submitted on behalf of Appellant, PETER E. AARON ("Aaron"), with respect to his appeal from the opinion and order of the Honorable District Court Judge Lee P. Gagliardi for the Southern District of New York, respectively filed May 5, 1977 and May 24, 1977, which permanently enjoined Aaron, his agents, servants, employees, attorneys and those persons in active concert or participation with him, from violating the registration and fraud provisions of the Securities Act of 1933 ("Securities Act") as found in Section 5(a)(1), 5(c) and 17(a) of the Securities Act 15 U.S.C. 77e(g), 77(e)(c) and 77g(a), as well as permanently enjoining violations of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5, 17 C.F.R. 240.10b-5 promulgated thereunder.

The purpose of this Reply Brief will be to emphasize the issues raised in Aaron's Brief, and to respond to certain of the matters and issues raised by the Plaintiff-Appellee ("SEC") in its Brief.

REVIEW OF THE FACTS

The Appellant's Brief correctly stated that Norman Schreiber ("Schreiber"), one of the defendants in the action, was a Registered Principal with E. L. Aaron & Co., Inc. ("Aaron & Co."), and was in charge of the Branch Office in Roslyn, New York. ^{1/} The SEC, however, has attempted to characterize Schreiber as a "salesman" who merely "transferred to the Branch Office". ^{2/} This fundamental misstatement of Schreiber's position with Aaron & Co. compounds the error of the District Court, which found that Schreiber was associated with Aaron & Co. as a Registered Representative and Branch Manager of Aaron & Co.'s Roslyn Heights office. ^{3/} The failure of the District Court to properly recognize Schreiber's position, including his responsibilities vis a vis Aaron & Co. and Aaron, constitutes reversible error.

This erroneous finding as to Schreiber's position at Aaron & Co. is restated in the SEC's Brief, when it states that the Appellant "had permitted Schreiber and Jacobson to sell Lawn-A-Mat stock..." ^{4/}

The only evidence adduced at the trial as to Aaron's position at Aaron & Co. was that he was assistant to the President. ^{5/} In such capacity, he merely assisted ^{6/} and did not manage, but monitored ^{7/} positions.

^{1/} Brief of Appellant, pp. 14-15.

^{2/} Brief of SEC, p. 4.

^{3/} SEC v. E. L. Aaron & Co., Inc., CCH Fed. Sec. L. Rep. ¶96,043, at p. 91,682 (S.D.N.Y. 1977).

^{4/} Brief of SEC, p. 5. Moreover, the evidence is also unclear as to the authorization given Schreiber to become a market maker in Lawn-A-Mat (Tr. 335); it may very well have been Edward Aaron alone

^{5/} Tr. p. 315.

^{6/} SEC Brief, p. 21, line 9.

^{7/} Tr. p. 324.

Aaron had no power or authority to permit or disallow Schreiber or other Aaron & Co. employees to sell Lawn-A-Mat stock. The only evidence adduced at the trial was to the effect that Schreiber talked to either Aaron or his father about wanting to trade Lawn-A-Mat stock.^{8/} This evidence falls short of proving that Aaron had any authority to tell Schreiber or anyone else that he could or could not make a market in Lawn-A-Mat stock or take any other actions.

With respect to the supposed misrepresentations made by Schreiber and other employees of Aaron & Co., it is conceded by the SEC, and the District found,^{9/} that Aaron himself made no misrepresentations.

As Dan Dorfman ("Dorfman"), Lawn-A-Mat's President and principal stockholder testified and personally told Aaron, Lawn-A-Mat had intentions of producing an automobile.^{10/} If Lawn-A-Mat had produced the automobile, common sense dictates that Lawn-A-Mat's publicly traded stock would have increased substantially in value. Thus, all of the representations brought into issue in the lower Court flow from Dorfman's representations that Lawn-A-Mat would produce an automobile.

The SEC's contention that Aaron took no affirmative steps to stop the alleged misrepresentations is correct. Yet, Aaron's failure to act cannot result in culpability, as Aaron had no authority or power to supervise the Roslyn Branch Office of Aaron & Co. where all the representations in issue originated. Further, there is not a scintilla of evidence that Aaron de facto supervised the Roslyn Branch Office or had the authority or duty to do so.^{11/}

^{8/} Tr. p. 335.

^{9/} SEC v. E. L. Aaron & Co., supra at 91,684.

^{10/} Tr. pp. 249-252, 253-257, 258-259, 383-384, 397-398, 407.

^{11/} Tr. pp. 348-350.

With respect to the transactions performed in accordance with Rule 144, the SEC states that since Aaron & Co. Co. was a marketmaker in Lawn-A-Mat, a sale of Dorfman's stock in the market, through Aaron & Co. as the selling broker, would not satisfy the requirements of Rule 144.^{12/} However, the SEC then incorrectly states that Aaron & Co. only appeared to purchase the stock from J. W. Weller & Co., Inc. ("Weller").^{13/} Aaron & Co. did, in fact, purchase the shares from Weller & Co., and all of the comparisons admitted in evidence from both Weller & Co. and Aaron & Co. so indicate,^{14/} a fact which the SEC concedes.

1. THE DISTRICT COURT ERRED IN FINDING APPELLANT AIDED AND ABETTED VIOLATIONS OF THE ANTI-FRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS.

A. The Alleged False Representations
Made by Aaron & Co. Employees

All of the alleged representations made by Schreiber and those under Schreiber's supervision as the principal of Aaron & Co.'s Roslyn Branch Office flowed from their belief that Lawn-A-Mat was going to produce an automobile. That belief was corroborated by the various photographs of the automobile shown to Lawn-A-Mat dealers by Dorfman.^{15/} It is undisputed that Lawn-A-Mat was interested in manufacturing a car and that Dorfman actually distributed photographs of it at a meeting attended by Schreiber, Dorfman and Aaron.^{16/}

^{12/} Brief of SEC, p. 11.

^{13/} Brief of SEC, p. 12.

^{14/} Plaintiff's Exhibits, 1, 2 and 3, Brief of Appellant, p. 32.

^{15/} Brief of SEC, p. 13.

^{16/} Tr., pp. 67-70, 85-86, 383-384.

The SEC's contention that Dorfman was not the President of Lawn-A-Mat during a portion of the time period in issue and thus had less day to day contact with Lawn-A-Mat is nonsensical. Dorfman's status as the principal stockholder, de facto Chairman of the Board and sometime President of Lawn-A-Mat, belies the inference which the SEC would have the Court conclude, that Dorfman was not familiar with the day to day operations of Lawn-A-Mat. Milton Kean's ("Kean") testimony that Lawn-A-Mat had no plans to manufacture an automobile is irrelevant, as the belief that Lawn-A-Mat would produce a car was premised on Dorfman's descriptions and representations. Further, Kean, as counsel to Lawn-A-Mat, was not an officer or member of the Board of Directors and would not have had knowledge of Lawn-A-Mat's day to day operations. The SEC properly states that Lawn-A-Mat had acquired an option to purchase United Stellar, a company with the facilities to manufacture a car. However, the SEC incorrectly states^{17/} that the management of Lawn-A-Mat never seriously considered exercising its option to purchase United Stellar. Fernando Erazo ("Erazo") testified that he told Dorfman that he, as Chief Executive Officer of Lawn-A-Mat, could not exercise the option to purchase United Stellar.^{18/} Yet, there is no testimony that Erazo or Dorfman ever communicated that business decision not to exercise Lawn-A-Mat's option to purchase United Stellar to anyone (emphasis added) at Aaron & Co. Further, Erazo's decision was subject to change by a changing of Lawn-A-Mat's management, which could have happened at any time by virtue of

^{17/} Brief of SEC, p. 16.

^{18/} Tr., p. 308.

Dorfman's controlling interest in Lawn-A-Mat. Thus, Dorfman's representations to Aaron and others regarding Lawn-A-Mat's production of a car were properly given credence by Aaron and others. Further, Dorfman's testimony indicates that Lawn-A-Mat, if properly managed, could have had sales of \$25,000,000 during the next five years.^{19/} The fact that information concerning the intended production of an automobile was not in Lawn-A-Mat's Annual Report on Form 10-K, or other documents in Aaron & Co.'s due diligence files is irrelevant despite the SEC's contention to the contrary, because generally such forms only report on past operations of a company and not its future projects. Accordingly, the District Court's findings are erroneous.

B. AARON HAD NO DUTY, RESPONSIBILITY OR
POWER TO SUPERVISE A BRANCH OFFICE,
WHICH BRANCH OFFICE WAS SUPERVISED
BY A REGISTERED PRINCIPAL

The SEC^{20/} incorrectly represents the Appellant's contention regarding a duty to supervise, by stating that the Appellant relies solely on the absence of an official title at Aaron & Co. Aaron does not merely contend that his lack of an official title at Aaron & Co. requires a finding in his favor. It is Aaron's position that regardless of any title which he did or did not have, he had no duty to supervise and, therefore, cannot be held liable as an aider and abettor for failing to stop persons he had no legal duty (or power) to stop. The specific duties which he had were

^{19/} Tr. p. 305.

^{20/} Brief of SEC, p. 17, 18.

submitted to the National Association of Securities Dealers, Inc. ^{21/} ("NASD") in 1971 by Dan Brecher, Esq., Aaron & Co.'s attorney, and that body, which has the responsibility to determine whether or not registration as a Principal is required, determined that ^{22/} registration by Aaron as a supervisory Principal was not required. If registration as a Principal, as determined by the governing regulatory body in that instance, was not required in 1971, and as ^{23/} the testimony indicates, Aaron's duties were less in 1974 and 1975, then, a fortiori, Aaron had no duty to supervise anyone at Aaron & Co., much less anyone at the Roslyn Branch Office. Further, Aaron relied on the NASD letter in not registering as a Principal. Thus, the refusal of the District Court to admit into evidence the 1971 Brecher Letter to the NASD and the response of the NASD constituted reversible error for the reasons set forth above and in Aaron's Brief. ^{24/} Additionally, the District Court should have admitted the Brecher Letter and the NASD's response as evidence of Aaron's state of mind that he did not believe that he had any duty or power to supervise employees at Aaron & Co.

The cases cited by the SEC ^{25/} supporting the proposition that persons exercising managerial functions may be held liable as aider and abettors are distinguishable and inapplicable, as they are devoid of any reliance on the alleged violators on an NASD interpretation, as in the case at bar. The District Court's ruling that the letters were too remote to be admitted overlooks the testimony that Aaron's duties were less in 1975 than in 1971 ^{26/} when the correspondence with the NASD occurred.

^{21/} Defendant's Exhibit L.

^{22/} Defendant's Exhibit M.

^{23/} Tr., p. 479.

^{24/} Brief of Aaron, pp. 8-13

^{25/} SEC Brief, p. 18.

^{26/} Tr. p. 319-30.

Despite the fact that a trial judge's rulings are in large measure insulated from full review by Appellate Courts, where there is an arbitrary exercise of power excluding relevant evidence which adversely affects the rights of a party, the trial court's exercise of discretion does not immunize the trial court from accountability.

The SEC asserts^{27/} that Aaron deliberately failed to register as a Principal with the NASD. Nothing could be further from the truth; and such an assertion would be valid only if the NASD in 1971 had determined that Aaron should register as a Principal and he had subsequently refused to do so. In this case, Aaron did not ignore the NASD's ruling, he relied on it.

At the very least, this case must be remanded to the District Court for further findings with respect to Aaron's position at Aaron & Co. and particularly with respect to the above described correspondence with the NASD.

Even assuming, arguendo, that Aaron possessed some managerial responsibility, that responsibility extended only to the main office where he was employed and certainly did not extend to the Branch Office, which was already within the responsibility of Schreiber, the Principal of that office.

The District Court assumed that Aaron had some power to stop Jacobson and Schreiber from making alleged misrepresentations concerning Lawn-A-Mat stock. In fact, the opposite is true. Schreiber, as the Registered Principal, possessed supervisory power over Aaron who was merely the assistant to the President. To hold

^{27/} Brief of SEC, p. 25.

otherwise would be to elevate a non-supervisory Registered Representative to a position superior to that of a supervisory Principal.

There is no evidence to indicate that Aaron had the power or duty to fire any personnel. The District Court makes the illogical assumption that Aaron could have stopped Schreiber and Jacobson merely because he did not. All of the evidence indicates that, whether as "liaison", or "assistant", or "trouble shooter", Aaron was only assisting his father or running errands for him. None of the verbal characterizations presented at the trial produce sufficient proof that Aaron possessed any legal duty to supervise Aaron & Co. employees. Almost all of the functions performed by Aaron are normally handled at brokerage houses by clerks. The District Court failed to distinguish between a filial duty and a legal duty. The SEC's recitation in its Brief^{28/} that Aaron held himself out to Kean as having supervisory responsibility over Schreiber and Jacobson draws on a fallacious inference. Aaron stated that the matter would be taken care of and testified that it was in fact taken care of by his father.^{29/} These actions bespeak a good assistant discharging a duty to his father, not a supervisor discharging any legal duty. The SEC's Brief continuously seeks to characterize Aaron's duties as "managerial". This bootstrapping argument does no more than assume the very conclusion which must be proven.

For example, the SEC asserts^{30/} that the statement in Appellant's Brief that several employees testified that Aaron had no supervisory responsibility at Aaron & Co. is erroneous.

^{28/} SEC Brief, p. 21.

^{29/} Tr., p. 349.

^{30/} Brief of SEC, p. 22, note 17.

Yet, no fewer than six witnesses testified that Edward Aaron "ran the show" at Aaron & Co., ^{31/} thus excluding Aaron as having any supervisory authority or responsibility.

Aaron can only be held responsible, as several cases have held, for violations committed within his sphere of responsibility. ^{32/} Any contrary result would extend liability for securities laws violations far beyond the scope of reason. The cases cited by the SEC ^{33/} for the proposition that individuals with supervisory responsibility have a duty to exercise vigilance when a remote indication of irregularity reaches their attention are inapplicable to this situation, as those cases apply only where individuals have supervisory responsibilities over employees. In the case at bar, it was Schreiber, and not Aaron, who had supervisory responsibility over the employees at the Roslyn Branch Office where the alleged violations took place. In this respect, the District Court's finding that Schreiber was merely a Registered Representative at the Roslyn Branch Office is clearly erroneous and has the effect of tainting all of the District Court's relevant findings.

C. SCIENTER IS A NECESSARY ELEMENT OF A CLAIM FOR RELIEF IN AN SEC INJUNCTIVE ACTION

It is not necessary in this Reply Brief to review the many cases decided since Ernst & Ernst v. Hochfelder ^{34/} which have taken contrary positions regarding the necessity of proving scienter-- "a mental state embracing intent to deceive, manipulate, or defraud" ^{35/} in SEC injunctive actions.

^{31/} Tr., pp. 366, 372-73, 426, 430, 434-35, 467.

^{32/} e.g., Schmidt, Sharp, McCabe & Co., Inc., 42 S.E.C. 745 (1965)
Midwest Planning Investments, Inc., 42 S.E.C. 558 (1965).

^{33/} Brief of SEC, p. 18.

^{34/} 425 U.S. 185 (1976).

^{35/} Id at 193, note 12.

It is sufficient to state that the question is before this Circuit again.

This Circuit, in Arthur Lipper Corp. v. SEC,^{36/} in^{37/} discussing the meaning of Section 10(b) of the Exchange Act, and its interpretation by the sponsors of the Act to the effect that Section 10(b) means "thou shalt not devise any other cunning devices",^{38/} adds the important note that "that phrase could not be regarded as including negligence..."^{39/}

Nothing could be more true. And as correctly stated in SEC v. American Realty Trust: "If the language and history of 10(b) is dispositive as to a scienter requirement in private actions, it must also be so for SEC enforcement actions, since such suits are creatures of statute rather than implied rights of action...."^{40/}

The argument of the SEC to the effect that an injunction should be granted more readily than in a private action, on the theory that such injunctive relief serves only as a "mild prophylactic"^{41/} ignores the realities of litigation against the SEC: in view of the tremendous expense of fighting an injunctive action, the severe damage to one's reputation and the very real threat that an injunction, if granted, would directly or indirectly put one out of business, it can hardly be maintained that injunctive relief should be granted lightly--indeed, an SEC injunction may very well serve as an economic death sentence and should be viewed as nothing less, thus requiring full and clear proof of a mental state embracing intent to deceive, manipulate or defraud.

^{36/} 547 F.2d 171 (2d Cir. 1976), cert. denied, 46 U.S.L. 3432 (Jan. 10 1978).

^{37/} 15 U.S.C. 78j(b).

^{38/} Arthur Lipper Corp. v. SEC, supra at p. 90,869.

^{39/} Ibid

^{40/} 1976-1977 CCH Fed. Sec. L. Rep. ¶95,913 at p. 71,440 (E.D. Va. 1977)

^{41/} Brief of SEC, p. 35.

The SEC's contention that regardless of whether a showing of scienter is required in an SEC injunctive action under Section 10(b) of the Exchange Act and 10b-5, scienter is not required in an action under Section 17(a) of the Securities Act,^{42/} is no more than an attempt to establish an easier standard for injunctive relief in one statute than another, when both the language and the alleged violations are the same. The better reasoning is that expressed in SEC v. American Realty Trust, where the Court held:

"Both anti fraud provisions--Section 10(b) of the 1934 Act, and Section 17 of the 1933 Act--contain almost identical language, a fact which even the SEC has admitted.... Both provisions have similar purposes. Accordingly, the Court concludes that scienter--an intent to deceive, manipulate or defraud--is also a necessary element in an action for injunctive relief brought by the SEC pursuant to Section 17a of the Securities Act of 1933."^{43/}

In addition, the Court in Malik v. Universal Resources Corp.,^{44/} although the case involved a private cause of action under the Securities Laws, properly recognized that since Section 17(a) is so similar to Section 10(b), the results should be identical:

"Furthermore, Courts and scholarly commentators alike have generally treated these provisions interchangeably as affording the same remedies and requiring identical proof to establish liability. To hold now that scienter is a required element of proof under Section 10(b) of the Exchange Act but not under Section 17(a) of the Securities Act would create an undesirable and, I believe, unintended asymmetry of coverage between the two acts which would

^{42/} 15 U.S.C. 77q(a).

^{43/} SEC v. American Realty Trust, supra, note 29 at p. 91,440.

^{44/} (Current) CCH Fed. Sec. L. Rep. ¶95,055 (S.D. Cal. 1976).

certainly result in all such future civil claims being brought under Section 17(a) to avoid the stiffer proof required of Section 10(b). Such a ruling would signal the easy circumvention and swift desuetude of Ernst." ^{45/}

Clearly, the fact that similar statutes result in dissimilar treatment by courts is inherently unfair. It is respectfully requested that this Circuit now properly apply the Hochfelder standard to SEC injunctive actions, and that this Circuit recognize no distinction between Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act with respect to the required proof to establish liability.

D. THE DISTRICT COURT'S FINDINGS OF
SCIENTER ARE CLEARLY ERRONEOUS,
REQUIRING REVERSAL OF THE DECISION

Assuming that scienter is required, the findings of the District Court in this respect were clearly erroneous and require reversal. It is undisputed that Aaron consulted with the attorney regarding the two critical issues in this case--(1) the question whether or not Aaron's duties at Aaron & Co. reached a managerial or supervisory level such that he would have to register with the NASD as a Principal, ^{46/} and, therefore, be potentially culpable for violations at the main office, and (2) the legality of the sales of restricted securities pursuant to Rule 144. ^{47/}

^{45/} Id. at p. 91,576.

^{46/} Tr., pp. 471-479.

^{47/} Tr., pp. 483-493.

It is difficult to conceive how a man who consults with counsel and the regulatory agency involved before behavior is engaged in can later be found to have "an intent to deceive, manipulate or defraud". For if the NASD, for example, had concluded in 1971 that Aaron's activities at Aaron & Co. were of such supervisory or managerial capacity that he should register with the NASD as Principal, it is fair to conclude that he would have done so. While such a ruling would not have been dispositive of this case, as being a Principal at the main office would certainly not in and of itself have created any responsibility over the activities of the Branch Office, nevertheless, it would have demonstrated the sincerity of Aaron's position in abiding by the decision of the body having jurisdiction over his activities. Conversely, the failure to admit the NASD letter ruling that he did not have to register as a Principal constituted error in not allowing Aaron to show reliance and a state of mind negating scienter.

Similarly, with respect to the sales made pursuant to Rule 144, Aaron had extended conversations with the attorney, and, as set forth in Aaron's Brief, ^{48/} he relied on such advice in directing the Rule 144 sales to another brokerage house, as required by Rule 144 itself and by the SEC interpretations thereof, ^{49/} which will be discussed more fully, infra.

In its Brief, ^{50/} the SEC makes the incredible assertion that if Aaron believed the representations made by Schreiber and Jacobson to be true, Aaron is conceding that he knew of the representations that were being made. It is, however, undisputed that

^{48/} Brief of Appellant, pp. 47-50.

^{49/} Brief of Appellant, pp. 28-38.

^{50/} Brief of SEC, p. 40, note 60.

the first warning of any kind made to Aaron concerning any representations being made was not until April, 1975. This warning resulted from a brief telephone call made by Kean ^{51/} to Aaron & Co.'s main office, which call was transferred to Aaron. It is undisputed that Aaron's personal knowledge, based upon his meeting with Dorfman, who was Lawn-A-Mat's President at the time, ^{52/} was substantially different from that told to him by Kean. Further, Schreiber, who was responsible for Lawn-A-Mat transactions, "emphatically believed" Dorfman. ^{53/} The SEC further states ^{54/} that the findings of the District Court that Aaron participated in Schreiber's and Jacobson's fraudulent activity regarding anything other than the existence of a car to be manufactured by Lawn-A-Mat are not disputed. However, without dispute, Aaron has continually asserted that he did not participate in the Lawn-A-Mat sales.

II. THE SALES OF UNREGISTERED STOCK CONFORMED WITH THE PROVISIONS OF RULE 144 AND THE SEC'S INTERPRETATIONS THEREOF, AND, THEREFORE, NO VIOLATION OF SECTION 5 OCCURRED

The SEC in its Brief certainly agrees that the shares owned by the Dorfman's could have been sold in Rule 144 transactions; its only objection is the manner in which the sales were made. The entire argument of the SEC centers around the fact that Aaron & Co. engaged in a "prearranged agreement". ^{55/} Apparently, the SEC chooses to ignore its own interpretations of Rule 144. In the first

^{51/} Tr., p. 198.

^{52/} Tr., pp. 258, 383, 438.

^{53/} Tr., p. 407.

^{54/} Brief of SEC, p. 41, note 61.

^{55/} Brief of SEC, p. 47.

Carolina Securities Corporation no action letter,^{56/} which the SEC does not deal with except to place said no action letter in a footnote, the inquiring broker asked whether it was true that the only way for the principal marketmaker in a stock to sell its customers' restricted stock under Rule 144 is by sending the customer to another broker: "this places both the seller and ourselves (Carolina Securities) at a disadvantage because by going to another broker/dealer who is not a marketmaker the stock can be sold readily with the broker acting as agent and our buying the stock."^{57/} The foregoing is a crystal clear example of a pre-arranged transaction. Nevertheless, the SEC in its response, stated that the interpretation of Carolina Securities was correct.

In a subsequent interpretive request by Carolina Securities Corporation,^{58/} the broker set forth a specific example just to clarify the SEC's interpretation. The specific statement was made: "therefore, if our customer contacted another broker/dealer he would be able to sell us (Carolina Securities) the stock, acting as agent for the seller, and apparently comply with the requirements of the Rule in respect to brokers' transactions."^{59/} The inquiror then asked the SEC, "...however, would not the sale of the stock through another broker/dealer acting as agent comply with Rule 144 even though the broker/dealer sells the stock to Carolina Securities Corporation?"^{60/} The SEC agreed, stating that, "a broker is otherwise free to sell to any broker/dealer; a broker/dealer purchasing as principal from another broker/dealer is in the position of any other purchaser of Rule 144 stock."

^{56/} 1976-1977 CCH Fed. Sec. L. Rep. ¶80,803 (Oct. 7, 1976).

^{57/} Ibid. at p. 87,095.

^{58/} 1976-1977 CCH Fed. Sec. L. Rep. ¶80,853.

^{59/} Ibid. at 87,257.

^{60/} Ibid.

This is the clearest example of a prearranged transaction which the Division of Corporation Finance of the SEC unqualifiedly endorsed, but the Division of Enforcement now seeks to enjoin. The SEC's argument^{61/} that Aaron would have appeared to have purchased the stock in the open market and would, therefore, be free to sell the stock to the public without registration is a "red herring". Aaron & Co. was doing no more than saving its customers a commission, which represented the basic purpose for the Carolina Securities no-action requests, and which was approved by the SEC itself.^{62/}

The SEC attempts to obscure its own interpretation of Rule 144 by calling the transaction a "sham". This characterization by the District Court of a prearranged transaction endorsed by the SEC ignores the legal interpretation of Rule 144 by the SEC's Division of Corporation Finance and thus constitutes reversible error as a matter of law. If the transactions effected by Aaron & Co. are now sought to be enjoined by the SEC, it is incumbent on that governmental agency to first change its own rules and interpretations thereof. Fundamental fairness requires that rules not be changed ex post facto.

III. THE LOWER COURT ERRED IN GRANTING IN-
JUNCTIVE RELIEF IN THE ABSENCE OF AARON'S
ACTUAL KNOWLEDGE OF THE FRAUD

This Court has recently held, in Hirsch v. duPont,^{63/} as cited with approval in Faturik v. Woodmere Securities, Inc.,^{64/} that in order to hold someone liable as an aider and abettor in a private action under Section 10(b) of the Exchange Act, "knowledge of the

^{61/} Brief of SEC, p. 12.

^{62/} Carolina Securities Corporation, supra, note 46 at 87,257.

^{63/} (Current) CCH Fed. Sec. L. Rep. ¶96,011 (2d Cir. 1977).

^{64/} (Current) CCH Fed. Sec. L. Rep. ¶96,063 (S.D.N.Y. 1977).

fraud and not merely the undisclosed material facts, is indispensable."^{65/} In Hochfelder, it must be remembered, liability was sought to be imposed on an alleged aider and abettor; in that case, the applicability of the Hochfelder standards to SEC injunctive actions was left open.^{66/} The SEC concedes that the question is open.^{67/}

Clearly, even assuming, arguendo, that mere negligence will suffice against a primary violator, something considerably more is necessary in order to enjoin an aider and abettor--actual knowledge, not merely of the facts but of the fraud, combined with "the knowing assistance of or participation in a fraudulent scheme,"^{68/} and, as in Hirsch v. duPont, an independent duty.

In this case, none of the foregoing elements of aider and abettor liability exist. Further, the granting of the injunction was based at least in part upon impermissible references to alleged violations not involving Aaron, which the SEC unsuccessfully attempted in its Brief,^{69/} to whitewash.

As adequately demonstrated at the trial, Aaron believed both Dorfman, President of Lawn-A-Mat at the time when Aaron met with him, and also believed Schreiber who "emphatically" believed in the truth of Dorfman's statements.^{70/} Aaron relied upon counsel and the NASD with respect to all of the issues in this case. Further Aaron had an unblemished record for 18 years in the securities business.

65/ Hirsch v. duPont, supra at p. 91,544

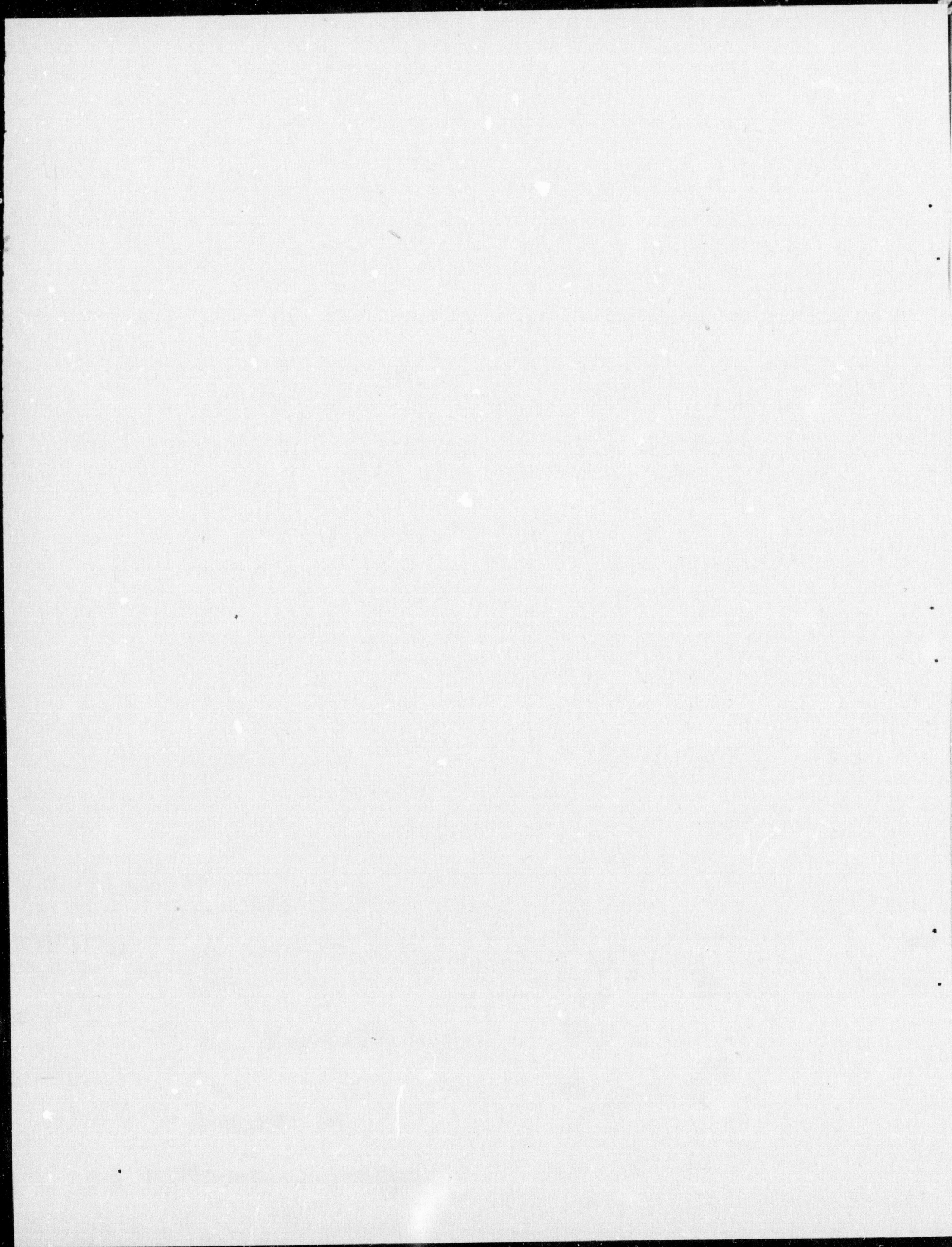
66/ Ernst & Ernst v. Hochfelder, supra p. 184, note 12.

67/ Brief of SEC, p. 54, note 79.

68/ Hirsch v. duPont, supra at p. 91,544; cf: Roll v. Blyth, Leiman Dillon & Co., (Current) CCM Fed. Sec. L. Rep. ¶96,275 (2d Cir 1978).

69/ Brief of SEC, p. 55, note 81.

70/ Tr., pp. 401-402.



CONCLUSION

On the basis of the foregoing, the issuance of an injunction against Aaron would be contrary to the evidence and contrary to law.

Respectfully Submitted,

GUSRAE, GREENE & KAPLAN
Attorneys for Defendant-Appellant
PETER E. AARON

Dated: February 13, 1978

[¶ 80,803] Carolina Securities Corporation.

Securities and Exchange Commission, Division of Corporation Finance. September 7, 1976. (Available October 7, 1976). Correspondence in full text.

Securities Act—Rule 144—Transactions by Broker-Dealers Who Are Market Makers—Broker Transactions.—A market maker who is approached by a holder of Rule 144 securities desiring to liquidate a block of stock must handle the liquidation through unsolicited orders from other broker-dealers. Section 4(4) of the Securities Act is a statutory exemption which limits the kinds of transactions which may be deemed exempt as "brokers' transactions" and the SEC staff does not see any statutory basis for enlarging the exemption through modification of Rule 144.

See ¶ 2705A and 2901, "Securities Act—Exemptions" division, Volume 1.

[SEC Staff Reply]

This is in response to your letter of August 20, 1976, regarding certain securities transactions by broker-dealers who are market makers pursuant to Rule 144 under the Securities Act of 1933 ("Act").

You advise that your firm has experienced two situations in which it is a market maker, and apparently the only market maker prepared to purchase a significant amount of stock. You state that the only way your firm can liquidate a block of stock for a Rule 144 holder is through unsolicited orders from other broker-dealers. You state that this places both the seller and your firm at a disadvantage because "by going to another broker-dealer who is not a market maker, the stock can be sold readily with the broker acting as agent and our buying the stock." You also state that the seller receives a lower price as a result of the commission he pays and if he is a customer of your firm, the rule forces him to do business elsewhere.

As you may know, paragraph (f) of Rule 144 provides that securities shall be sold in brokers' transactions within the meaning of Section 4(4) of the Act. Section 4(4) provides an exemption from the registration requirements of the Act for "brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders." Paragraph (g) of the Rule defines the brokers [brokers'] transactions in Section 4(4) to include transactions in which a broker does no more than execute a sell order as agent and receives no more than the usual and customary commission. The broker may not solicit buy orders, but may inquire of other brokers or dealers who have indicated an interest in the securities within the preceding 60 days.

Except as may be modified by the foregoing, your interpretation is correct. Since Section 4(4) of the Act is a statutory exemption which limits the kinds of transactions which may be deemed exempt,

¶ 80,803

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FIRST CAROLINA SECURITIES LETTER

we do not see any statutory basis for enlarging the exemption through modification of Rule 144.

[Letter of Inquiry]

Since the adoption of Rule 144 we have experienced one problem which I believe we commented on before the rule was adopted, but, in any event, it is a provision of the rule which holders of restricted securities simply can't understand, and we thought you could perhaps provide some clarification.

Under the rule securities sold must be sold in a normal brokerage transaction where the broker receives the customary commission and does not solicit any orders. Initially, in the case of a market maker it was necessary for the market maker to discontinue his market making activity while handling the sale of Rule 144 securities, but this was subsequently changed.

We have experienced two situations in which we not only are a market maker, but

apparently the only market maker who is usually prepared to purchase a significant amount of stock, and we also distribute the stock retail. Under these circumstances, when we are approached by a holder of Rule 144 securities who wishes to liquidate a block of stock, our only means of handling the liquidation is through unsolicited orders from other broker/dealers. This places both the seller and ourselves at a disadvantage because by going to another broker/dealer who is not a market maker, the stock can be sold readily with the broker acting as agent and our buying the stock. In this case the seller usually receives a lower price . . . and if he is a customer of our firm the provision of the rule almost forces him to do business elsewhere.

We are writing to inquire if our interpretation of rule as indicated is correct and, if so, does the situation described indicate the need for some modification of the rule. We would appreciate hearing from you.

[780,853] Carolina Securities Corporation.

Securities and Exchange Commission, Division of Corporation Finance. November 8, 1976. (Available December 8, 1976.) Correspondence in full text.

Securities Act—Exemptions—Rule 144—Brokers' Transactions.—The SEC staff was not persuaded that the "brokers' transactions" provisions of Rule 144 should be modified at the present time. A request to modify the rule in order to prohibit a broker-dealer from doing indirectly what he cannot do directly was considered within the context of a market maker's willingness to bid for shares as principal from a Rule 144 seller, his inability to buy them directly, and his ability to buy them from another broker-dealer after the Rule 144 seller sold the stock to that firm. The market maker observed that, absent such a prohibition, it is felt that there is almost an obligation to inform the customer of the alternative course of action, which involves sending the customer to a competitor and the customer's receipt of probably less for his stock in most cases (when commissions are taken into account). The SEC staff called attention to the prohibition in (g)(2) of Rule 144 concerning solicitation and arranging for solicitation of customers' orders but stated that a broker is otherwise free to sell to any broker-dealer and a broker-dealer purchasing as principal from another broker-dealer is in the position of any other purchaser of Rule 144 stock.

See ¶ 2705A, "Securities Act—Exemptions" division, Volume 1.

[SEC Staff Reply]

This is in reply to your letter of September 17, 1976 regarding broker dealer transactions pursuant to Rule 144.

The example you cite is that given in your letter of August 20, 1976 where as a market maker you are willing to bid for the shares of a Rule 144 seller, but such purchase as a principal is prohibited by the Rule. You

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SECOND CAROLINA SECURITIES LETTER

state that if the seller contacted another broker/dealer the latter would be able to sell the stock to your firm. You are of the opinion that since the bid of your firm to the other broker/dealer would probably be the same as that which you would make to the seller if you could purchase it directly, the seller would receive less for the stock by the amount of the commission to the broker/dealer. You state that some modification of the Rule is in order that would prohibit a broker/dealer from doing indirectly what he cannot do directly. In the absence of such a prohibition, you feel that you have an obligation to inform the Rule 144 seller, which happens to be your customer, of the alternative course of action.

As we pointed out in our letter of September 7, 1976, Rule 144 relates to brokers' transactions exempted from the registration provisions of the Securities Act of 1933 by Section 4(4) of that Act. Since the Rule provides that the securities shall be sold in brokers' transactions within the meaning of Section 4(4), a Rule 144 seller would, therefore, presumably pay commissions to any broker/dealer acting as agent as required by Section 4(4).

A prohibition is set forth in paragraph (g)(2) of the Rule as to transactions in which a broker "neither solicits nor arranges for the solicitation of customers orders...". A broker is otherwise free to sell to any broker/dealer; a broker/dealer purchasing as principal from another broker/dealer is in the position of any other purchaser of Rule 144 stock. We are not persuaded that the Rule should be modified at the present time.

I hope that this is helpful to you.

[Letter of Inquiry]

I appreciate your letter of September 7 in response to my inquiry regarding certain securities transactions by broker/dealers pursuant to Rule 144 of the 1933 Act.

While I think you have answered my question, I would like to submit a specific example just to be sure my interpretation is correct.

Recently a customer contacted us to sell 5,000 shares of stock to establish a tax loss. The stock sells for less than \$5.00 a share. We are the principal market maker and I believe the only one who would bid for 5,000 shares. Because the customer is an affiliate of the issuer we concluded that the sale would be subject to Rule 144. In this particular case it happened not to be restricted stock, having been purchased out of the market, but our understanding is that

such sales are subject to all of the provisions of Rule 144 except that which requires a two-year holding period.

We were quite willing to bid for the 5,000 shares, but a purchase as principal is prohibited by the rule and we couldn't sell it as agent because we did not know of a buyer. Obviously there are other broker/dealers who are aware that we are a market maker and would likely bid for 5,000 shares. Therefore, if our customer contacted another broker/dealer he would be able to sell us the stock, acting as agent for the seller, and apparently comply with the requirements of the rule in respect to brokers' transactions. Since the bid we would make for the stock to the broker/dealer would, in all probability, be the same which we would make to the seller were we able to purchase it directly, the seller would receive less for his stock by the amount of the commission, which in this case would probably amount to \$400.00 or more.

It is clear that we could not purchase the stock from the seller for our own account as principal; however, would not the sale of the stock through another broker/dealer acting as agent comply with Rule 144 even though the broker/dealer sells the stock to Carolina Securities Corporation?

We have assumed the answer to the above question would be in the affirmative and felt morally obligated to tell the customer we were prohibited by Rule 144 from purchasing his stock, but pointed out that we could purchase it from another broker/dealer who probably could handle the sale and comply with the requirements of Rule 144. Needless to say, our customer thought that a rule which creates such a situation needs some modification.

If there is no statutory basis for permitting a broker/dealer under these circumstances to purchase Rule 144 stock as principal, then it would seem that some modification of the rule is in order that would prohibit a broker/dealer from doing indirectly what he cannot do directly. In the absence of such a prohibition, we feel we almost have an obligation to inform the customer of the alternative course of action, and in so doing we not only are sending our customer to a competitor, but in most cases he receives less for his stock. In this particular case the customer decided for the present not to sell his stock, but there have been instances in the past where sales have been made to us through other broker/dealers which we feel sure were being made by our customers involving Rule

Federal Securities Law Reports

87,258

144 stock which we could not purchase directly from them.

STATE OF NEW YORK)
COUNTY OF NEW YORK) ss .

ROBERT LA GRASSA, being duly sworn,
deposes and says that deponent is not a party to the action,
is over 18 years of age and resides at 62-20 60th RD
MASPEETH, N.Y.

That on the 15 day of FEBRUARY, 1978,
deponent personally served the within REPLY BRIEF OF
DEFENDANT APPELLANT PETER E. AARON
upon the attorneys designated below who represent the
indicated parties in this action and at the addresses below
stated which are those that have been designated by said
attorneys for that purpose.

~~By leaving _____ true copies of same with a duly~~
~~authorized person at their designated office.~~

By depositing 2 true copies of same enclosed
in a postpaid properly addressed wrapper, in the post office
or official depository under the exclusive care and custody
of the United States post office department within the State
of New York.

Names of attorneys served, together with the names
of the clients represented and the attorneys' designated
addresses.

GLYNN MAYS, ESQ.
SECURITIES + EXCHANGE COMMISSION
ATTORNEY FOR PLAINTIFF-APPELLEE
WASHINGTON, D.C. 20581

Robert La Grassa

Sworn to before me this

15th day of February, 1978

Michael DeSantis
MICHAEL DeSANTIS
Notary Public, State of New York
No. 03-0930908
Qualified in Queens County
Commission Expires March 30, 1979